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No. 146

In the Supreme Court of the United States

OCTOBER TERM, 1939

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v.

JOHN THOMAS SMITH

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INDEX

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The Solicitor General, on behalf of Joseph T. Higgins, Collector of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered in the above cause on March 29, 1939.

OPINIONS BELOW

In the District Court, the case was submitted to a jury and a judgment based upon the verdict was entered May 10, 1938. (R. 33–34.) The opinion of the Circuit Court of Appeals (R. 767–769) is reported in 102 F. (2d) 456.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 29, 1939 (R. 770). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to deduct a "loss" arising out of an alleged sale, without any business purpose, of securities to a corporation wholly owned and controlled by the taxpayer.

STATUTE INVOLVED

This is set forth in the Appendix, *infra*, p. 20.

STATEMENT

The only issue here involved is whether the taxpayer is entitled to deduct a loss allegedly arising out of a sale to his wholly-owned corporation, the Innisfail Corporation, which took place on December 29, 1932. Determination of this issue requires a rather full consideration of the circumstances in which Innisfail was created and of its prior transactions with the taxpayer.

1. *Creation of Innisfail.*—On June 14, 1926, taxpayer caused the formation of Innisfail Corporation, paying the expenses attending its formation, and providing "dummy" incorporators, individuals who were on the legal staff of General Motors

Corporation and thus subordinates of taxpayer, general counsel of that corporation (R. 52, 116–117, 76).

On June 15, 1926, Messrs. Russo, Hogan, Gaynor, and Carroll, all subordinates of taxpayer, three of whom were incorporators, executed letters of resignation from their positions as directors and officers to take effect upon the acceptance of the board of directors of Innisfail Corporation. (R. 130–131.) Taxpayer, president of Innisfail Corporation (R. 169), became a director March 12, 1927, and, with Mr. Russo and Mr. Hogan, constituted the board of directors from that time through the year 1932 (R. 133, 185–186). During all of that time, Mr. Russo's resignation as a director was pending subject to action by the board of directors (R. 186).

All of the stock of Innisfail was issued to taxpayer, save a few shares, issued to these subordinates to qualify them as directors, which were promptly endorsed over to taxpayer (R. 117–118). As consideration for the stock of Innisfail Corporation, taxpayer transferred to it his rights under an option agreement (R. 118, 370–371).

Pursuant to this option agreement (R. 697–698) between taxpayer and a Mr. Bassett, taxpayer had the right to exchange 5,005 shares of Chrysler preferred for 26,477 shares of Chrysler common (R. 172). Prior to June 14, 1926, when Innisfail Corporation was formed, taxpayer had standing in his own name and in his possession the 26,477 shares

of Chrysler common, and Mr. Bassett had the 5,005 shares of Chrysler preferred, at least as collateral under the option agreement (R. 372–373). On the books of Innisfail, a gain of $515,000 was recorded as the result of the exchange of 5,005 shares Chrysler preferred for 26,477 shares Chrysler common. (R. 244.) With money furnished by the taxpayer, Innisfail paid taxes of about $69,000 on such gain. (R. 246–247.) The tax to an individual on such transaction would have been about $127,000. (R. 244–252.)

The 26,477 shares of Chrysler common stock received in exchange for 5,005 shares Chrysler preferred were not transferred out of the name of the taxpayer into that of Innisfail Corporation. (R. 120.) There was no corporate resolution authorizing the taxpayer to act as nominee for the 26,477 shares of Chrysler common stock. (R. 121.)

2. *Purposes and operations of Innisfail.*—The Innisfail Corporation was formed by taxpayer for the purpose of avoiding inheritance taxes and income taxes (R. 118–119). At the time he formed the Innisfail Corporation, he had in mind the taxable gain which would accrue from the exchange of Chrysler preferred for Chrysler common (R. 119). And he knew that a corporation would not pay a tax on its income which an individual would have had to pay as a result of the dividend payments on the Chrysler stock contributed by him to Innisfail Corporation (R. 142).

When Innisfail Corporation opened a bank account in 1927, a resolution authorized the president [taxpayer] to borrow money and to obtain credit for the corporation with the bank on such terms as might seem to him advisable, and authorized payment from the corporate funds on its check signed by the president (R. 136).

A resolution adopted November 28, 1929 (R. 164), authorized the president "to sell any and all of the securities owned by this corporation at such time and upon such prices, terms, and conditions as he may see fit." No officer other than the taxpayer ever purchased or sold securities for Innisfail Corporation. (R. 162.) There was no instance where the board of directors did not agree with the position of the taxpayer as to the purchase and sale of stock for the corporation (R. 161, 186). At the end of December, 1932, Innisfail Corporation had investments in 11 issues of securities which were carried at a value of $791,751.92 and of that amount all, except securities having a value of approximately $30,000, were acquired by the corporation from the taxpayer (R. 150, 182).

No one but the taxpayer ever advanced money to, or withdrew money from Innisfail Corporation. (R. 152.) Innisfail Corporation had no telephone, office space nor official stationery other than those used by the taxpayer personally. (R. 165.) It paid no rent. (R. 159.) Prior to 1934, it had no safe deposit box in its own name (R. 268). It

had no creditors other than the taxpayer. (R. 152, 183.) It had no payroll save payments to Mr. Doty, the taxpayer's secretary, for part-time services; it paid no salaries to officers. (R. 159, 183.)

After testifying that no resolution authorized the taxpayer to act as nominee for Innisfail Corporation, the taxpayer explained (R. 121) that Innisfail Corporation "was a very informal corporation. Everybody in the Innisfail Corporation knew what the situation was and approved of the method of doing business and what was done." The taxpayer further testified that when the Innisfail Corporation was about to lend money to taxpayer, there was no formal meeting to discuss the matter, that the corporation's situation and affairs was known and approved by all the officers and directors, and that this "was an informal corporation" (R. 163).

Taxpayer disposed of his interest in the Innisfail Corporation to members of his family on December 22, 1934 (R. 69–70), subsequent to the passage of the Revenue Act of May 10, 1934.

3. *Earlier Transactions.*—During the years 1926 to 1931, approximately $400,000 was paid to taxpayer as dividends on the Chrysler stock, standing in his name, the option rights to which he had transferred to Innisfail in exchange for its stock. These dividends were received by the taxpayer personally and the funds were used by him. (R. 134–135, 137, 139, 141, 143, 144, 145, 614–615.) Entries were made on taxpayer's books and on the books

of Innisfail Corporation indicating that the taxpayer owed Innisfail the amount of dividends received in such manner. (R. 134, 614.) In 1932, taxpayer ordered the Chrysler Corporation to pay to Innisfail dividends on Chrysler stock owned by Innisfail and standing in the name of the taxpayer. (R. 146.)

On December 6, 1929, Innisfail Corporation sold to taxpayer 4,412 shares of Chrysler stock and as the result of such sale to him a loss of $139,000 was reflected on its income tax return. (R. 218–220.) Innisfail had acquired these 4,412 shares through the taxpayer on July 19, 1928, when the taxpayer had paid for the subscriptions to these shares issued in his name, the corporation owing him the amount of the subscriptions. (R. 141, 222.) Entries were made upon the books of taxpayer and the corporation to reflect a debt from the sale of December 6, 1929, reducing the corporation's indebtedness to taxpayer (R. 141, 614).

On December 28, 1929, the taxpayer sold to Innisfail Corporation 1,000 shares of stock of Aldebaran Corporation for $160,800, and on December 31, 1929, 1,900 shares of stock of Hudson Motor Company for $106,400 (R. 141–142). Taxpayer reported a loss on these shares on his individual return. (R. 142.) He selected these securities in order to reflect a taxable loss (R. 166, 167). Innisfail Corporation at this time had no money with which to purchase such stock. The taxpayer caused entries to be made on his books and on the

books of Innisfail Corporation to record the transactions of sale and increase the indebtedness of Innisfail Corporation to the taxpayer (R. 143, 614). No note was executed, and no interest was charged (R. 143).

During 1930, dividends on the 1,900 shares of Hudson Motor stock which taxpayer had sold to Innisfail in 1929 were received in cash by him. (R. 143.) Entries in his books and the books of Innisfail would record a debt from him to the corporation in connection with the receipt by him of such dividends. (R. 145.)

On September 30, 1930, Innisfail Corporation sold to taxpayer, for $195,000, 10,000 shares of common stock of Chrysler Corporation, standing in his name (R. 144). This lot of 10,000 shares was part of the original block of 26,477 shares of Chrysler common which taxpayer had transferred to Innisfail in June of 1926 in exchange for all of the stock of Innisfail. (R. 614–615.) An entry was made on the taxpayer's books and the corporation's books to record the sale, and to evidence the debt due by taxpayer, converting a debt due from Innisfail to the taxpayer into a debt owing by taxpayer to Innisfail (R. 144, 615). Taxpayer did not execute a note to the corporation, nor did it charge him interest (R. 144).

The taxpayer owed $68,364.68 to Innisfail on December 29, 1932 as the result of items reflecting the various transactions between them, principally

those set out above (R. 66). There were balances due between them at the end of each year, Innisfail owing money through September, 1930, and taxpayer owing money thereafter. No note was ever executed by Innisfail Corporation to the taxpayer, nor by him to the corporation, nor was any interest charged by either on balances outstanding (R. 139, 140, 143, 144).

4. *The Transaction in Question.*—On December 29, 1932, the taxpayer caused certain of his personal securities to be transferred into the name of Innisfail Corporation. These securities consisted of the following (R. 7):

500 shares Electric Auto-Lite Company
500 shares Firestone Tire & Rubber Company
332 shares Gaynor Electric Company
1,553 shares Investrad Corporation
18,324 shares National Baking Company
200 shares National Sugar Refining Company

Prior to the transaction the taxpayer had unrealized losses on these personal securities. When he picked these securities, he had in mind the tax incidence of their selection for sale (R. 167–168). He selected sufficient securities so that their aggregate prevailing market value approximated his indebtedness of $68,364.68 to Innisfail (R. 66, 167).

The taxpayer was given credit on the books of Innisfail in the amount of $60,923.80, the sales price determined upon for these securities, fixed at mar-

ket value or book value (R. 7, 72–75). He then gave to Innisfail a check for $7,440.88 (R. 66, 145–146, 235–236), which represented the difference between the value of the securities and his alleged debt to Innisfail.

The securities were kept in a safe deposit box which was not in the name of Innisfail (R. 115-116, 133, 268). Innisfail received the dividends paid on them (R. 200, 319–320, 322–323, 324–325). It did not reconvey any of such securities to the taxpayer (R. 61).

5. *The Proceedings Below.*—The court charged the jury (R. 377–399) that the jury was to determine whether the transfers were to an entity which had an existence and identity separate and apart from the taxpayer (R. 386–387), but definitely stated to the jury that the mere fact that taxpayer owned all the stock did not prove that the corporation did not have such separate existence (R. 388). The jury was instructed (R. 389) not to draw any unfavorable inference because of any tax avoidance motive on the part of the taxpayer. The court charged that the mere fact that a corporation does business only with its sole stockholder is not enough to deny its separate existence, but that this is a circumstance the jury is entitled to consider in ascertaining whether there was in truth and fact an actual and substantial sale or group of sales involved in this case (R. 396–397).

Finally, the court charged that the losses contemplated by the tax laws were actual and real and

sustained in a transaction having a regular business purpose (R. 397); that a mere gesture without the vital intent to change ownership is not to be recognized as a sale because it has some of the appearances of a sale (R. 398); that the property after being sold must be outside the control and domination of the seller and outside his power of disposition (R. 398).

After considering the evidence and the inferences to be drawn therefrom, in the light of the court's instructions, the jury returned a general verdict for the Government on the issue here involved.[1] (R. 402.) The court below ruled that the taxpayer's motion for a directed verdict should have been granted. It reversed the judgment, and remanded the cause. It originally directed entry of verdict for the taxpayer (R. —) but on motion for rehearing directed a new trial (R. 770).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer's motion for a directed verdict should have been granted.

2. In holding that a sale to a corporate entity must be recognized for tax purposes regardless of the nature of the corporation or the reality or business substance of its transactions.

3. In holding that a loss is sustained upon a sale to a corporation, which is wholly owned and con-

[1] The jury returned a verdict for the taxpayer with respect to the fraud penalty imposed by the Commissioner (R. 402).

trolled by the vendor, was formed and used to avoid taxes, and has engaged in transactions practically with the vendor alone, the sale having no business purpose.

4. In limiting the principles enunciated in *Gregory* v. *Helvering*, 293 U. S. 465, strictly to a reorganization case.

5. In holding that there was no evidence or legitimate inference to support the verdict of the jury on the question of the reality or finality of the alleged sale of securities by the taxpayer to his wholly-owned corporation.

6. In weighing the evidence and in reaching a conclusion upon the facts (that there was an actual sale) contrary to that reached by the jury.

7. In reversing the judgment of the trial court and in remanding for a new trial.

REASONS FOR GRANTING THE WRIT

The Circuit Court of Appeals held that the Innisfail Corporation was a separate legal entity from the taxpayer, though it was a one-man, wholly-owned corporation which purchased, held and sold securities as he caused it to, and that the sale of securities by the taxpayer to the corporation, without any reacquisition by the taxpayer, was an actual sale to a real buyer and resulted in a deductible loss to the taxpayer.

1. Our first proposition assumes that the court below was correct in holding that there was a fully completed sale of the stock to Innisfail, a legal en-

tity separate from the taxpayer. But we insist that the Revenue Acts do not provide for recognition of a loss resulting from a transfer to a purchaser wholly owned by and controlled by the seller, in a transaction having no business purpose or significance. The decision of the court below exalts form above substance in a way contrary to the intent of the tax laws. *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *United States* v. *Phellis*, 257 U. S. 156; *Lucas* v. *Earl*, 281 U. S. 111.

The transaction in the present case lies outside the plain intent of Section 23 (e), permitting the deduction from gross income of losses sustained during the taxable year. Under this section losses must be realized by some closed and completed, identifiable event determining the existence and amount of the loss. The loss must be a real loss, "actual and present." *Burnet* v. *Huff*, 288 U. S. 156, 161; cf. *Helvering* v. *Owens*, 305 U. S. 468. A taxpayer cannot claim a loss merely because his securities have declined in value. *New York Ins. Co.* v. *Edwards*, 271 U. S. 109, 116. Nor can he take the deduction by making a formal sale of the securities, retaining dominion and control (*Shoenberg* v. *Commissioner*, 77 F. (2d) 446 (C. C. A. 8th)), as through an understanding permitting him to repurchase (*Nicholson* v. *Commissioner*, 90 F. (2d) 978 (C. C. A. 8th); *Commissioner* v. *Dyer*, 74 F. (2d) 685 (C. C. A. 2d), certiorari denied, 296

U. S. 586; *Commissioner* v. *Riggs*, 78 F. (2d) 1004 (C. C. A. 3d), certiorari denied, 296 U. S. 637). Similarly in the case of a transfer to a wholly-owned and controlled corporation, without a business purpose (where any agreement to repurchase would be wholly unnecessary), the loss cannot be deducted. The taxpayer in every practical sense retains full dominion and all the advantages of ownership, while the corporation lacks even that independent judgment which might be attributable to a wholly-owned corporation charged with the destiny of a separate business enterprise. The Revenue Act contemplates genuine losses, recognized as such by the business world, not those resulting from sales to a wholly-owned and controlled corporation, with no place in regular business channels. Deductible losses might as well be allowed when the taxpayer on his books transfers an investment from one account to another.

In *Gregory* v. *Helvering*, 293 U. S. 465, the taxpayer's wholly-owned corporation transferred securities to a new corporation, organized to avoid taxes, which issued all its shares to the taxpayer, and which was subsequently dissolved and liquidated by the distribution of the securities to the taxpayer. The Court held that although the transaction had the form of a corporate reorganization, it was without any business purpose and the nonrecognition provisions of the income tax law were inapplicable. The Court said that although the

motive of tax avoidance was not pertinent, the transaction upon its face was outside the plain intent of the statute. This principle was extended in *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, where the Court ignored that feature of a reorganization plan pursuant to which money received by a corporation was turned over to its stockholders subject to their agreement to assume and pay off an indebtedness of the corporation in the same amount.

The court below regarded *Gregory* v. *Helvering*, 293 U. S. 465, as a decision of limited significance, stating that it "had to do with a pretended reorganization not within the scope of that statute" (R. 769). But the principle established in that case necessarily reaches beyond the particular section of the Revenue Act under which it arose.

The decision below is in conflict with *Commissioner* v. *Griffiths*, 103 F. (2d) 110 (C. C. A. 7th), now pending on the taxpayer's petition for certiorari, No. 49, this term, where the taxpayer defrauded in a sale of stocks, was about to make a profitable settlement, and, in order to avoid taxes, first organized a wholly-owned corporation and sold the stock, together with his cause of action, to the corporation on an installment basis. The court pointed out that the corporation had no legitimate business purpose of substantial character, relied upon the principle of the *Gregory* case instead of restricting it to its particular situation,

and refused to permit the transfer to the wholly-owned corporation to dictate tax consequences. Accord: *Loewenberg* v. *Commissioner,* 39 B. T. A. (No. 119), promulgated May 10, 1939. The applicability of the *Gregory* decision to a sale made to a controlled corporation in order to establish a loss is also indicated by *Wickwire* v. *United States* (E. D. Mich.), decided February 4, 1939, 1939 Prentice-Hall Federal Tax Service, vol. 1, par. 5.274. See also *Groves* v. *Commissioner,* 99 F. (2d) 179 (C. C. A. 4th); *Continental Oil Co.* v. *Jones,* 26 F. Supp. 694 (W. D. Okla.); *Jackson* v. *Commissioner,* 39 B. T. A. (No. 136), promulgated May 23, 1939.

In the case at bar, as in the *Gregory* and *Griffiths* cases, the wholly-owned corporation was formed to avoid taxes (R. 118–119, 142), and used for that purpose (R. 142, 166, 167). Although in the *Gregory* and *Griffiths* cases the corporation was formed to handle the particular transaction scrutinized by the court, it hardly can be deemed material that in the case at bar the corporation had been previously organized and had engaged in various transactions prior to 1932. If the principle of the *Gregory* case were limited to what might be called single-transaction corporations, it would place a premium on a protracted as opposed to a sporadic use of the corporate fiction for tax avoidance purposes.

In substance, the court below held that any formally perfect sale to a wholly-owned corporation is sufficient to control tax consequences. The Circuit

Court of Appeals for the Seventh Circuit, in the *Griffiths* case, held to the contrary. The only possible distinction which we can see is that in the *Griffiths* case the corporation was a mere conduit by which the taxpayer disposed of property to a third party, while in a case such as the one at bar (unless the taxpayer exercises his unrestricted power to cause a resale to himself) title to the stock remained in the corporation. This conceivable distinction does not seem to be sound and was not suggested in any way by the court below.

2. We have assumed above that there was a completed sale of the stock to Innisfail, but that such a sale as this cannot result in a deductible loss. But if the court below were correct in holding that anything which amounts to a "sale" is sufficient to permit a deductible loss, then this transaction cannot be termed a sale.

The court below recognized that under its theory the crucial inquiry was whether the taxpayer could show a real sale to an actual buyer, and it stated that this was shown (R. 769). However, the jury had been instructed (R. 388) to find if the corporation really functioned as something separate and apart from the taxpayer; to ascertain whether there was in fact an actual sale involved in this case (R. 397), or whether the transaction was a mere gesture without the vital intent to change ownership (R. 398). The jury's general verdict represents a finding that there was no sale, undoubtedly embodying a conclusion that at the time of the sale the tax-

payer had no intention to part with ownership of the securities, or had a present intention to leave them in such a status that he could reacquire them whenever he wished. The jury's verdict was amply supported by inferences to be drawn from the circumstances surrounding the nature of the alleged delivery and consideration, together with the history of the transactions between the parties. The finding of fact that there was no sale should stand on appeal. *Commissioner* v. *Bank of California, etc.,* 80 F. (2d) 389 (C. C. A. 9th). We submit that the court below, under its theory, committed flagrant error in weighing the evidence and in substituting its conclusion for that of the jury on the question of whether or not there was a real sale to an actual buyer. Cf. *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, and *McCaughn* v. *Real Estate Co.,* 297 U. S. 606.

3. It may be appropriate to consider the bearing of Section 24 (a) (6) of the Revenue Act of May 10, 1934, c. 277, 48 Stat. 680, *infra,* p. 20, which provides that no deduction shall be allowed for loss from sales between an individual and a corporation in which he owns more than 50% in value of the outstanding stock. This section does not indicate that the decision below is correct. The section goes much further than the Government's position here, making no distinctions in terms of business purpose or the extent of control by the shareholder. In any event an intent to close up possible loopholes (H. Rep. No. 704, 73d Cong., 2d Sess., p. 23; S. Rep.

No. 558, 73d Cong., 2d Sess., p. 27) is consistent with uncertainty as to the previous law and a sense of caution, as much as with an alleged recognition of its shortcomings.

The 1934 amendment does not demonstrate that the case at bar is unimportant. The decision below, in conflict with the opinion in the *Griffiths* case, states a limitation on the principle of *Gregory* v. *Helvering* which has application to situations not covered by the amendment.[2] It may also be noted that this Court has granted a writ if certiorari to resolve a conflict of circuits notwithstanding the repeal of the statute involved and although no similar case was pending or could arise.[3]

CONCLUSION

Therefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBERT H. JACKSON,
Solicitor General.

JUNE, 1939.

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[2] Thus, the *Griffiths* and *Loewenberg* cases involved a question of spreading gain, rather than deduction for loss, and *Continental Oil Co.* v. *Jones* involved an excise tax.

[3] *Cahn* v. *United States*, 296 U. S. 558; 297 U. S. 691; see also *Santa Monica Int. Park Co.* v. *United States*, 99 F. (2d) 450 (C. C. A. 9th), certiorari granted, No. 606, 1938 Term, February 27, 1939, dismissed on stipulation of counsel March 29, 1939; *United States Trust Co.* v. *Commissioner*, 296 U. S. 537, 481.

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APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

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